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No. 96-930

In the Supreme Court of the United States

OCTOBER TERM, 1996

MIDWEST INVESTMENTS, INC., ET AL., PETITIONERS

v.

SECURITIES AND EXCHANGE COMMISSION

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

WALTER DELLINGER
Acting Solicitor General
Department of Justice
Washington, D.C. 20530-0001
(202) 514-2217

RICHARD H. WALKER
General Counsel

PAUL GONSON
Solicitor

JACOB H. STILLMAN
Associate General Counsel

ROSS A. ALBERT
Special Counsel
Securities and Exchange Commission
Washington, D.C. 20549

QUESTIONS PRESENTED

1. Whether Congress has constitutional authority to prohibit the intrastate use of the mails and the telephone in furtherance of securities fraud.

2. Whether petitioners' liability for disgorgement of the proceeds of their fraudulent activities was properly ordered to be joint and several.

3. Whether petitioners' claim that the Securities and Exchange Commission brought this civil law enforcement action in order to obtain evidence for use in a future criminal proceeding provides a basis for relief in this case.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 2a-12a) is unreported, but the judgment is noted at 85 F.3d 630 (Table). The opinions of the district court (Pet. App. 13a-32a) are unreported.

JURISDICTION

The judgment of the court of appeals was entered on May 6, 1996. A petition for rehearing was denied on July 16, 1996. Pet. App. 1a. The petition for a writ of certiorari was filed on September 3, 1996. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioner Midwest Investments, Inc. (Midwest) was a broker-dealer with its principal place of business in Columbus, Ohio. Pet. App. 3a. According to petitioners, Midwest's retail securities business was conducted entirely within the State of Ohio. Midwest's business depended on extensive use of (i) the telephone, to make solicitations to prospective customers; and (ii) the mails, to dispatch transaction confirmations and promotional materials. Gov't C.A. Br. 13-14, 19.

Midwest was owned by Midwest Management Company (MMC). Petitioner Michael J. Eberle was president of Midwest and owned 20% of MMC. Petitioner Robert D. Hodge was Midwest's general sales manager and indirectly owned a majority of MMC. Petitioners Thomas L. Costello, Donald H. Gilliland, Thomas J. VanEcho, and Thomas J. Williamson were sales managers at Midwest under Hodge's direct supervision; each owned, directly or indirectly, 5% of MMC. See Pet. App. 18a-19a.

2. The instant case involves a law enforcement action brought by respondent Securities and Exchange Commission (Commission). The action arises out of petitioners' sale of stock in Reitz Data Communication, Inc. (Reitz). The district court found that petitioners had charged customers excessive undisclosed markups of greater than 150% in over 800 transactions; that they had "made misstatements and omitted to state material facts to investors about the offer and sale of [Reitz] securities"; and that they had "used their control of the supply and demand for Reitz to establish and maintain artificially high prices for Reitz Stock." Pet. App. 27a. The court also held that

petitioners had acted with scienter. *Id.* at 27a-28a. The court concluded that petitioners' conduct violated the antifraud and penny stock disclosure provisions of the federal securities laws. *Id.* at 28a-30a.[1]

The district court subsequently held that petitioners were jointly and severally liable for disgorgement of $791,625, the amount of the trading profits on the sales of Reitz stock. The court also assessed civil penalties of $25,000 each against petitioners Hodge and Eberle, and $10,000 each against petitioners Costello, Gilliland, VanEcho, and Williamson. See Pet. App. 6a-7a.

3. The court of appeals affirmed. Pet. App. 2a-12a. The court rejected petitioners' contention that the intrastate character of the transactions in question precluded application of the federal securities laws. The court concluded that "because [petitioners] made extensive use of the mails to perpetrate their fraud, * * * the application of the Acts to [petitioners] was a valid exercise of Congress' power under the Postal Clause, U.S. Const. art. I, § 8, cl. 7." Pet. App. 8a. The court observed that "the courts have long expressly held that the antifraud provisions of the securities laws apply when the mails are used, even when the mailings are entirely intrastate." *Ibid.*

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[1] See Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a); Sections 10(b), 15(c) and 15(g) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), 78o(c) and 78o(g); and Rules 10b-5, 15c1-2, 15c1-8, 15c2-6 (now 15g-9), and 15g-3 through 15g-6, 17 C.F.R. 240.10b-5, 240.15c1-2, 240.15c1-8, 240.15c2-6 (now 240.15g-9), and 240.15g-3 through 240.15g-6, promulgated thereunder. Section 15(g) and implementing Commission rules require that a broker-dealer doing business in low-priced or penny stocks make specified disclosures to customers.

The court of appeals also rejected petitioners' contention that the district court had erred in requiring them to disgorge the profits from the sale of Reitz stock. Pet. App. 11a-12a. In light of the district court's finding that petitioners had acted with scienter, the court of appeals "conclude[d] that the district court's order of disgorgement was within its equitable powers and that [petitioners'] challenge to the order of disgorgement is meritless." *Id.* at 12a.

4. Petitioners filed a petition for rehearing. They argued, for the first time, that the district court had erred in imposing joint and several liability with respect to the order of disgorgement, and that the Commission had brought this enforcement action in bad faith in order to obtain evidence for use in a criminal prosecution. See Pet. 5-6. The court of appeals denied the petition without opinion. Pet. App. 1a.

ARGUMENT

The unpublished decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Further review is therefore unwarranted.

1. The provisions of the Securities Exchange Act of 1934 that are pertinent to this case apply to fraudulent schemes effected through "the use of any means or instrumentality of interstate commerce or of the mails." 15 U.S.C. 78j; see also 15 U.S.C. 78*o*(c), 78*o*(g). The Exchange Act defines "interstate commerce" to include "intrastate use of * * * a telephone." 15 U.S.C. 78c(a)(17). Similarly, the pertinent provision of the Securities Act of 1933 applies whenever there is an "offer or sale of any securities by the use of any means or instruments of transportation or commu-

nication in interstate commerce or by the use of the mails." 15 U.S.C. 77q(a). Petitioners nevertheless contend (Pet. 7-12) that neither the Postal Clause nor the Commerce Clause of the Constitution authorizes the regulation of intrastate securities fraud involving use of the mails or the telephone. That argument is contrary to well-established precedent.

a. The Postal Clause of the Constitution, Art. I, § 8, cl. 7, vests in Congress the power to regulate "the entire postal system of the country," and authorizes Congress to proscribe the use of the mails in furtherance of a fraud or other wrongful conduct. *Ex parte Jackson*, 96 U.S. 727, 732 (1877). "When the power to establish post-offices and post-roads was surrendered to the Congress [by the States], it was as a complete power, and the grant carried with it the right to exercise all the powers which made that power effective." *Ex parte Rapier*, 143 U.S. 110, 134 (1892). Congressional authority under the Postal Clause includes the power to prohibit improper uses of the mails, even where the mailings are wholly intrastate. See *Smith* v. *United States*, 431 U.S. 291, 305 (1977) (federal prosecution for mailing obscene materials may be based on intrastate mailings, since the statute "was one enacted under Congress' postal power, * * * and the Postal Power Clause does not distinguish between interstate and intrastate matters.").[2]

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[2] See also *Badders* v. *United States*, 240 U.S. 391, 393 (1916) (Holmes, J.) ("The overt act of putting a letter into the postoffice of the United States is a matter that Congress may regulate. Whatever the limits to its power, it may forbid any such acts done in furtherance of a scheme that it regards as contrary to public policy, whether it can forbid the scheme or not."). The federal mail fraud statute, currently codified at 18

Petitioners cite no decision, and we are aware of none, suggesting that the federal securities laws are inapplicable to intrastate mailings.[3] They rely instead (see Pet. 7) on this Court's statement that "Congress may not exercise its control over the mails to enforce a requirement which lies outside its constitutional province." *Electric Bond & Share Co.* v. *SEC*, 303 U.S. 419, 442 (1938). That statement appears to mean only that federal regulation of the mails is subject to independent constitutional restrictions on congressional authority, such as the First Amendment. Cf. *United States Postal Service* v. *Council of Greenburgh Civic Ass'ns*, 453 U.S. 114, 126 (1981) ("However broad the postal power conferred by Art. I may be, it may not of course be exercised by

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U.S.C. 1341, has uniformly been construed to reach intrastate mailings. See, *e.g.*, *United States* v. *Cady*, 567 F.2d 771, 776 n.7 (8th Cir. 1977) (congressional authority under the Postal Clause extends to all fraudulent uses of the mails, and "[i]t is irrelevant that all of the mailings in this case may have been intrastate in nature"), cert. denied, 435 U.S. 944 (1978); *Landry* v. *Air Line Pilots Ass'n*, 901 F.2d 404, 428 (5th Cir.) (listing as element of mail fraud the interstate or intrastate use of the mails for the purpose of furthering or executing the scheme or artifice to defraud), cert. denied, 498 U.S. 895 (1990).

[3] As the court of appeals observed, "[t]he courts have long expressly held that the antifraud provisions of the securities laws apply when the mails are used, even when the mailings are entirely intrastate." Pet. App. 8a. See *Bogy* v. *United States*, 96 F.2d 734, 737 (6th Cir.), cert. denied, 305 U.S. 608 (1938); *Holmes* v. *United States*, 134 F.2d 125, 135 (8th Cir.), cert. denied, 319 U.S. 776 (1943); *SEC* v. *Timetrust, Inc.*, 28 F. Supp. 34, 40 (N.D. Cal. 1939); *Northern Trust Co.* v. *Essaness Theatres Corp.*, 103 F. Supp. 954, 961-962 (N.D. Ill. 1952); *United States* v. *Tallant*, 407 F. Supp. 878, 885-886 (N.D. Ga. 1975).

Congress in a manner that abridges the freedom of speech or of the press protected by the First Amendment to the Constitution.").[4] Because the Commerce Clause is an affirmative grant of legislative authority, not a limitation on Congress's use of its other enumerated powers, there is no "interstate commerce limitation on Congress' power" (Pet. 7) under the Postal Clause.

b. Petitioners also contend (Pet. 8-12) that congressional power under the Commerce Clause, Art. I, § 8, Cl. 3, does not extend to the regulation of intrastate telephone communications. Because petitioners' extensive use of the mails provided a constitutionally sufficient basis for regulation of their activities under the Postal Clause, acceptance of their Commerce Clause argument would not affect the judgment below. In any event, petitioners' argument lacks merit.[5]

In *United States* v. *Lopez*, 115 S. Ct. 1624 (1995), this Court held that Congress had exceeded its power under the Commerce Clause in enacting the Gun-Free School Zones Act of 1990, a statute that made it

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[4] To the extent that the quoted language in *Electric Bond* is ambiguous, the Court's subsequent decision in *Smith* v. *United States*, *supra*, makes clear that congressional power under the Postal Clause extends to the regulation of intrastate mailings.

[5] The courts of appeals have consistently held that the Commerce Clause authorizes Congress to regulate securities fraud whenever the telephone is used, even for solely intrastate calls. See *Loveridge* v. *Dreagoux*, 678 F.2d 870, 873-874 (10th Cir. 1982); *Gower* v. *Cohn*, 643 F.2d 1146, 1151 (5th Cir. 1981); *Aquionics Acceptance Corp.* v. *Kollar*, 503 F.2d 1225, 1228 (6th Cir. 1974); *Myzel* v. *Fields*, 386 F.2d 718, 727 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968).

a federal crime to possess a firearm in a school zone. The Court explained that "[t]he [Gun-Free School Zones] Act neither regulates a commercial activity nor contains a requirement that the possession [of a firearm] be connected in any way to interstate commerce." *Id.* at 1626. "[B]y its terms [the statute] has nothing to do with 'commerce' or any sort of economic enterprise, however broadly one might define those terms." *Id.* at 1630-1631. The Court observed, however, that Congress (1) "may regulate the use of the channels of interstate commerce," *id.* at 1629; (2) "is empowered to regulate and protect the instrumentalities of interstate commerce, or persons or things in interstate commerce, even though the threat may come only from intrastate activities," *ibid.*; and (3) may "regulate those activities having a substantial relation to interstate commerce," *id.* at 1629-1630. All three categories set forth in *Lopez* are implicated by petitioners' fraudulent activities, and particularly by their frequent use of the telephone—an instrumentality of interstate commerce—for the effectuation of commercial transactions. Congress has ample authority to prohibit such activities.[6]

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[6] Petitioners also suggest (Pet. 10-12) that the regulation of intrastate securities fraud violates their First Amendment rights to engage in commercial speech or advertising. The cases on which they rely make clear, however, that the First Amendment offers no protection to fraudulent commercial speech. See *Ibanez* v. *Florida Dept. of Business and Professional Regulation*, 512 U.S. 136, 142 (1994) ("false, deceptive, or misleading commercial speech may be banned"); *Edenfield* v. *Fane*, 507 U.S. 761, 768 (1993) ("our cases make clear that the State may ban commercial expression that is fraudulent or deceptive without further justification"); *Central Hudson Gas & Elec. Corp.* v. *Public Service Comm'n*, 447 U.S. 557, 563 (1980) ("[T]here can be no constitutional objection to the sup-

2. Petitioners contend (Pet. 12-21) that the district court erred in imposing joint and several liability for the disgorgement award of $791,625. Because petitioners failed to raise that argument until their rehearing petition in the court of appeals, this Court should not address it. But even if the claim had been properly preserved, petitioners' fact-bound challenge would not warrant this Court's review.

a. In the district court, petitioners argued that the instant case was one of "first impression," and that disgorgement was therefore an inappropriate remedy. Pet. App. 15a. They did not, however, contest the Commission's submission that the court should impose joint and several liability with respect to any disgorgement order. Similarly in the court of appeals, petitioners argued that the district court had erred in ordering disgorgement but did not contest the imposition of joint and several liability. See *id.* at 11a-12a. Petitioners' challenge to that aspect of the district court's decision was first raised in their petition for rehearing in the court of appeals. See Pet. 5-6. That court denied rehearing without opinion. See Pet. App. 1a. Because petitioners failed to raise their claim in a timely fashion, the lower courts had no occasion to address petitioners' fact-based contentions regarding joint and several liability. There is no reason for this Court to address those contentions in the first instance.

b. Imposition of joint and several liability for disgorgement was appropriate in this case in light of the

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pression of commercial messages that do not accurately inform the public about lawful activity. The government may ban forms of communication more likely to deceive the public than to inform it").

individual petitioners' disregard for the corporate formalities regarding Midwest and MMC, and their complete domination and control over those entities. The Commission's summary judgment memorandum explained, *inter alia*, that (1) the individual petitioners had received interest-free, undocumented, or inadequately documented loans from Midwest and MMC; (2) some of the individual petitioners, including Eberle, Gilliland, VanEcho, and Williamson, had used Midwest's checking account to pay personal expenses such as mortgage, cable television, and car phone bills; and (3) the record contained evidence of inadequately documented transfers of substantial "management fees" from Midwest to MMC and an affiliated entity. See SEC's Brief in Support of Motion for Summary Judgment at 94-100. Petitioners' fact-bound challenge to this aspect of the district court's decision raises no issue of general importance. Review by this Court therefore is not warranted.

3. Petitioners contend (Pet. 21-24) that the Commission brought this civil law enforcement action in bad faith, "with the ultimate goal to gather enough information to prosecute criminal indictments against the defendants," in violation of the First and Fifth Amendments. Petitioners first raised that argument in their petition for rehearing in the court of appeals.

Furthermore, petitioners make their assertion (Pet. 21-24) in generalized and conclusory terms. Nothing in the record supports petitioners' claims of bad faith, and the Commission denies them. The fact that evidence obtained by the Commission in a civil investigation may lead to (and be used in) a criminal prosecution is entirely proper, as is the maintenance of parallel civil and criminal proceedings. See *United*

States v. *Kordel*, 397 U.S. 1, 11-12 (1970); *SEC* v. *Dresser Indus., Inc.*, 628 F.2d 1368, 1374-1387 (D.C. Cir.) (en banc), cert. denied, 449 U.S. 993 (1980); see also, e.g., *Donaldson* v. *United States*, 400 U.S. 517, 532-536 (1971); *In re Grand Jury Subpoena*, 920 F.2d 235, 240 n.5 (4th Cir. 1990); *United States* v. *Unruh*, 855 F.2d 1363, 1374 (9th Cir. 1987), cert. denied, 488 U.S. 974 (1988); *United States* v. *Parrott*, 425 F.2d 972, 976 (2d Cir.), cert. denied, 400 U.S. 824 (1970).

In any event, petitioners' claim is premature, since they have never faced federal criminal charges for the activities underlying the Commission's lawsuit.[7] If petitioners are ever indicted for their activities at Midwest, and if they can substantiate their claims of bad faith, they may seek appropriate relief in the criminal proceedings. See *Kordel*, 397 U.S. 11-12; *Unruh*, 855 F.2d at 1374; *United States* v. *Teyibo*, 877 F. Supp. 846, 855-857 (S.D.N.Y. 1995), aff'd, 101 F.3d 681 (2d Cir. 1996) (Table). See also *United States* v. *Blue*, 384 U.S. 251, 254-255 (1966) (holding dismissal of indictment improper, because suppression remedy would suffice if claim substantiated).

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[7] Petitioners Hodge, Costello, and Gilliland were indicted on state charges of securities fraud and related offenses. (Hodge was convicted, and Gilliland pleaded guilty to some of the charges; the charges against Costello were subsequently dismissed.) Those charges, however, all arose from activities that antedated those at issue here, and involved a different penny stock firm, Dublin Securities. No overlap existed between the claims alleged in the Commission's complaint and the state criminal charges against Hodge, Costello, and Gilliland.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

WALTER DELLINGER
Acting Solicitor General

RICHARD H. WALKER
General Counsel

PAUL GONSON
Solicitor

JACOB H. STILLMAN
Associate General Counsel

ROSS A. ALBERT
Special Counsel
Securities and Exchange Commission

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